

**FROM THE WORLD OF GENERAL INSURANCE**

**Asbestos developments**

A GIRO working party has published a report on the future cost of UK asbestos claims, estimating this to be in the range £8–20bn, of which approximately half is expected to fall on the UK insurance and reinsurance industry. The cost is estimated to arise from between 80,000 and 200,000 claimants over the next 30 years. This is, of course, in addition to the cost to UK insurers and reinsurers of their share of the asbestos problems originating in US and elsewhere in the world.

The reorganisation plan for Combustion Engineering, negotiated by its owners ABB Ltd, may need to be revised after a US federal appeals court threw doubt on the plan's fairness to certain classes of asbestos claimants. In early December, the appellate court sent the plan back to a lower court for further consideration. The principal grounds for this decision were that claims against certain subsidiaries of Combustion Engineering were included, although the assets of those subsidiaries were not as they were outside the reorganisation plan.

**World Trade Center (WTC)**

A New York jury has found in favour of Silverstein Properties Inc on the most recent phase of litigation on the number of events making up the terrorist attacks on the World Trade Center. As a consequence the nine insurers involved (and/or their reinsurers) will have to pay double the \$1.13bn sum insured on their proportion of the property risk. The decision is, not surprisingly, subject to appeal by the insurers.

RAND Corporation has produced a report on the compensation provided to victims of the attacks on 11 September 2001. This shows that, of the total \$38.1bn paid to individuals and corporations, just over half (\$19.6bn) was paid by insurers, nearly 40% (\$15.8bn) from local, state, and federal government sources (including the Victims Compensation Fund), and the balance (\$2.7bn) from charitable sources. RAND question whether any future situation of a similar nature would receive similar backing from government and charity, and suggests that the tort system may play a very significant role in the event of a repeat of such a scenario.

**Contingent commissions/  
placement service  
agreements**

Further fallout from the investigations carried by the New York attorney-general, Eliot Spitzer (see *The Actuary* December news columns), include the cutting of the workforce of Marsh & McLennan Cos Inc (MMC) by around 3,000, including the removal of the president and the chairman of the global insurance unit where over 2,000 of the staff reduction was expected to be made, and where the improprieties had been identified. In addition, MMC announced that it was establishing a \$232m reserve from which any settlement agreed with Mr Spitzer would be paid. Elsewhere, Hartford and Zurich have sacked a small number of staff in connection with the investigations; the former believing those staff had been insufficiently co-operative with Mr Spitzer, the latter in relation to their involvement in the underlying activities which were said to have been in breach of New York anti-trust laws.

Further insurers have also been subpoenaed by Mr Spitzer as he continues his investigations, which have also been extended into the area of finite reinsurance and other non-traditional products, and particularly the extent of disclosure of the impact of such products. Investigations have also commenced into certain legal malpractice insurance products. Several large firms of brokers have announced the results of investigations which have been carried out into the detail of the use of contingent commissions and placement service agreements, and generally these have been presented as a 'fairly clean bill of health' with nothing more than minor breaches of their codes of conduct. Although the larger brokers have agreed to stop collecting contingent commissions, several smaller firms with such income have not stated that they intend to follow this lead.

In the light of Mr Spitzer's findings disclosed to date, it is understood that reforms currently being considered to increase the federal role in the insurance regulatory system are being re-evaluated to consider whether they would prevent such practices in future, and if not how they could be modified to assist in addressing such problems.

**Compensation culture**

In November, there was considerable argument in the press following a conference speech by the Lord Chancellor and secretary of state for constitutional affairs, Lord Falconer, to the effect that spurious compensation claims were a blight on society, and the government intended to check the extent to which they were put forward. He placed a considerable part of the blame for this on claims management companies and suggested a form of self-regulation may be introduced. He also stated that a working party was to be established by the government to investigate the issue, although he ruled out fundamental changes to the conditional fee rules or the

introduction of a cap on compensation. The response from representatives from the personal injury lawyers was predictably adverse to any tightening of the rules in this area, and at least one such lawyer denied the existence of a compensation culture, including a scathing attack on the findings of the 2002 GIRO working party which estimated that the compensation culture cost approximately £10bn per annum; clearly the amounts could have changed since that estimate was made.

**Queen's speech**

The Queen's speech at the beginning of the new parliamentary session in November contained various items of interest to general insurers. In particular, the suggestion of tightening of rules on anti-social behaviour, a new road safety bill (including provisions to reduce the number of uninsured drivers), and a draft corporate manslaughter bill (which may have the effect of increasing the cost of employers' liability insurance) were mooted. Details on all of these are scant at present, and in any case there is a strong possibility that one or more of them may be lost if they are overtaken by the calling of a general election in the first half of 2005, as widely predicted.

**Large losses**

Recent notable general insurance incidents/losses include:

- **Niigata earthquakes** (23 and 27 October). The latest available insured loss estimate, according to the General Insurance Association of Japan, is that the cost of these earthquakes is only \$130m, much less than initial fears. This is believed to be a combination of the relatively limited geographical scope of the damage, the mainly agricultural, and sparsely populated, nature of the area, and the fact that only just over 10% of households in the Niigata prefecture have earthquake cover.
- **Selendang Ayu** (early December). This bulk carrier ran aground in Alaska en route for China, and subsequently split in two and suffered substantial leakage of oil, and lost six members of the crew. The ship was entered with the Swedish P&I Club, but had additional hull and machinery coverage placed in Malaysia, Norway, and London.
- **IntelSat communications satellite** This was declared a total loss by its owners following a sudden electrical problem. It is understood to be self-insured by IntelSat.
- **Australian storms** (13 December). Damage from these storms along the east coast of

*continued on p16*

**Large losses** *continued from p14*

Australia, including the area from the Gold Coast to Sydney) are initially estimated to cost around A\$13m, much of which is in the Sydney area.

■ **Earthquake and tsunamis** (26 December). The insurance impact of this enormous social catastrophe which has left well over 150,000 dead and millions homeless, mainly in the south of Asia, is unlikely to be commensurate with the social and economic cost to the nations concerned. The initial estimate of insurance cost is in the region of \$10bn, which is likely to be heavily concentrated in those areas most frequented by western tourists, as most of the other losses will be uninsured.

**Current Issues Newsletter**

Other recent developments are covered in the General Insurance Current Issues Newsletter, which can be accessed via the profession's website.

The latest edition is from January, and covers regulatory issues, solvency issues, Irish developments, other international issues, and claims and legal issues.

 DAVID HART

**Continuing acquisitions of closed life funds**

Following the ground-breaking acquisition of the closed funds of Royal & Sun Alliance by Resolution Life in the summer, activity accelerated recently as three transactions were announced:

- ◆ the acquisition of Swiss Life UK by Resolution Life for a consideration of £205m;
- ◆ the acquisition by Britannic Group of the funds of Cornhill Life for £110m; and
- ◆ the acquisition by Sun Capital and TDR Capital from HHG of the life funds of Pearl, NPI, and London Life for a total of £1,025m.

All three acquirers indicated a continuing interest in pursuing further deals, in which pursuit it is believed that Swiss Re and Old Mutual also are engaged.

**sigma**

The Indonesian earthquake in the closing days of 2004 is likely to add significantly to what Swiss Re's *sigma* had already reported as a record total of property

**The 'last chance saloon' for voluntarism?**

The Employer Task Force on Pensions presented on 13 December its report into occupational pension schemes to Alan Johnson, secretary of state for work and pensions, with a clear warning that action needs to be taken if we wish to maintain the current voluntary system rather than face compulsion in future.

(More at [www.employertaskforce.org.uk](http://www.employertaskforce.org.uk).)

The taskforce was set up by the government in July 2003. An employer-led body with union representation, its role is to

consider how employers can help increase pension provision within a voluntary framework and to advise the secretary of state on the role of employers in the pensions partnership. The recommendations of the taskforce, including particularly that companies should aim to achieve over time combined employer/employee contribution levels of around 10–15%, with employers ideally providing two-thirds of this, were quickly endorsed by the Association of Consulting Actuaries.

insurance claims. Even prior to the Christmas quake and tsunami, more than 21,000 people around the world lost their lives as a result of natural and man-made catastrophes in 2004. The catastrophes caused overall economic losses of about \$105bn worldwide. Property insurers across the globe had to contend with claims of approximately \$42bn. The full *sigma* study, including the effects of the Indian Ocean disaster, will be published in March 2005 at [www.swissre.com](http://www.swissre.com).

December saw publication of the latest Swiss Re *sigma* study, 'The impact of IFRS on the insurance industry', which finds that while international financial reporting standards taking effect in 2005 will increase transparency, they may also bring higher earnings and capital volatility.

**Pension fund management and accounting**

The Financial Economists Roundtable (FER) issued significant criticism of current (mainly North American) practice on 22 December. The statement included four specific suggestions:

- ◆ demanding reversal of the measure in the Pension Funding Equity Act of 2004 which allowed companies to value liabilities using a proportion of corporate bond yields rather than Treasury bond yields;
- ◆ requiring the Pension Benefits Guaranty Corporation (PBGC) to charge risk-related premiums to underfunded schemes so as to reduce the current high probability of requiring ultimately to be rescued by the taxpayer;
- ◆ requiring pension funds to invest overwhelmingly in marketable securities

and to report regularly on market values of assets, including stricter rules for market-consistent valuation of illiquid assets;

- ◆ eliminating the practice of smoothing deficits over multiple years which in the view of the FER at times 'creates the illusion of improvement for plans whose position is in fact worsening'.

Professor Elroy Dimson of London Business School noted that various of the suggestions, including for example that in relation to the PBGC, translated into a UK context.

The FER statement followed days after the IASB had issued amendments to IAS19 Employee Benefits. The IASB decided to allow the option of recognising actuarial gains and losses in full in the period in which they occur, outside profit or loss, in a statement of recognised income and expense. This option is similar to the requirements of the UK standard, FRS17 Retirement Benefits.

Previously IAS19 had required actuarial gains and losses (unexpected changes in value of the benefit plan) to be recognised in profit or loss, either in the period in which they occur or spread over the service lives of the employees. Many entities choose to spread the gains and losses. Under the amendment, entities that at present spread the gains and losses are not required to change their approach, but are now free to choose to do so. In particular, the amendment allows companies that are already showing the surplus or deficit in full under FRS17 to continue with their present policy.

The approach adopted by IASB attracted different views from actuarial consultants. Watson Wyatt favoured it as affording choice for companies, but Lane, Clark &

Peacock criticised the potentially very different treatments by companies of pensions costs.

## New ethical standards for auditors

The Auditing Practices Board (APB) published on 17 December final versions of new ethical standards for auditors. Actuaries may wish to scrutinise these in that they may signal the standards which would apply to actuaries and perhaps to actuarial firms in the 'independent oversight' context apparently favoured by the Morris Review (see p32).

The new standards were cautiously welcomed by accountancy bodies, although there was clearly considerable anxiety surrounding their development. A particular difficulty seemed to be the reconciliation of the need for confidence in quoted company audits with the need for cost-efficient certification of accounts for small and medium-sized enterprises. The APB has sought to achieve this by allowing an 'audit lite' approach for the latter.

## Mutual insurers

Government was quick to welcome the report by Paul Myners on governance of mutuals published 20 December. Principal recommendations include:

- Promoting greater engagement by life mutuals of their members, through guidance on fair and accessible voting procedures on a member relations strategy. This includes promoting dialogue with members as well as facilitating communication

among members. Members also have a clear responsibility to look after their own interests as the effective owners of life mutuals.

- Proposals to better inform life mutual members and the market through providing better information, including on directors' remuneration and, for large mutuals, publication of forward-looking strategic information in the form of an operating and financial review.

- Promoting adherence to best-practice corporate governance through producing a life mutual-specific piece of guidance. This takes the form of a number of annotations to the Combined Code to reflect the particular characteristics of life mutuals. The review's objective is that this code will be used by the FSA as its benchmark when it looks at governance as part of its risk-monitoring process;

- Proposals that give particular prominence to the need for a strong independent element on life mutuals' boards, and underline the importance of board appraisals. Monitoring of business risks should be an explicit function of the non-executive directors; and

- Helping equip non-executives to deal with the challenges they face in monitoring a complex, technical business. Proposals in the report aim to foster informed discussion and challenge. The company secretary or equivalent in friendly societies has a very valuable and active role to play in this regard and in supporting non-executives more generally.

The Myners report was preceded by a report from the Parliamentary All-Party Group for Building Societies and Financial

Mutuals on 9 December which concluded:

- ◆ Standard Life is wrong: regulation does not cause demutualisation.
- ◆ The status of mutuals enables them to offer financial products at good value for money.
- ◆ The existence of mutual businesses forces PLCs to be more competitive.
- ◆ Mutuals work to combat financial exclusion.
- ◆ Mutuals serve markets ignored by PLCs.
- ◆ Mutuals contribute to community life.

Adrian Bailey MP, who chairs the all-party group, commented: 'We have established once and for all that mutuals are good for consumers. Those who have experienced demutualisation have paid the price in higher costs and lower benefits.'

## REPORT

### National Association of Pension Funds (NAPF) autumn conference 18 November 2004

Terry Faulkner, chairman of the NAPF, opened the conference by recalling that over 2004 we have seen pension scheme trustees being perceived as potential 'deal breakers', and corporations increasingly facing the need to manage risk and modernise their benefit arrangements. Terry hoped that the Pensions Bill would act as a catalyst for the design of pension schemes that will meet the future demands of the modern workplace.

Lord Matthew Oakeshott, Liberal Democrat pensions spokesman, then gave the audience an insight into some of the issues that had been discussed during the evolution of the Pensions Bill, and his hopes for the future of pensions provision.

### 30th NAPF annual survey

Christine Farnish, NAPF chief executive, discussed some of the key findings from the 2004 NAPF annual survey:

- ◆ The rate of closure of final salary pension schemes has fallen. 10% of final salary schemes have been closed to new members in the past 12 months compared to 26% in 2003.
- ◆ 71% of private sector schemes have increased the employer contributions in order to address funding pressures and 41% have increased employee

## Citizen's pension is feasible

The National Association of Pension Funds (NAPF) has published an interim report commissioned from the Pensions Policy Institute (PPI) on how to move towards a citizen's pension. The report shows how the transition to a citizen's pension from the current system can be managed in a practical and affordable way. 'Although the citizen's pension is simple, the transition needs a lot of thought, because of the complexity in the current pension system', said Alison O'Connell, director of the PPI, who led the institute's work on the project.

A consultation period will be held to gather feedback and input for the next

phase of work. The interim report and a summary of conclusions are at: [www.pensionspolicyinstitute.org.uk](http://www.pensionspolicyinstitute.org.uk) and [www.napf.co.uk](http://www.napf.co.uk).

'It is easy to draw up a wish list of what a pension policy should include', said Tom Ross, past chairman of the NAPF and chairman of the PPI, who led the group of pension experts who steered the project. 'It is harder to make the tough decisions necessary to move forward with a realistic and comprehensive reform package. It is to the credit of the NAPF that they are addressing the full set of issues and are now seeking views.'

## 'What fates impose: facing up to uncertainty'

In a British Academy lecture with the above title on 1 December which echoed some of the issues addressed by the Morris Review, Mervyn King, governor of the Bank of England, discussed why it has proved difficult in collective decisions to understand, explain, and manage risk. He said that risk, luck, fate, uncertainty, probability theory – all are reminders that most decisions in life involve risk. We accept that luck has a part to play in our personal lives. But in our collective life the role of probabilities only rarely takes centre stage. Yet it is difficult to imagine an informed and useful discussion of most public policy issues without a careful analysis of the risks involved.

The governor said: 'Whether in policies for health or transport, matters monetary or meteorological, in times of war and peace, decisions should reflect a balance of risks. Yet policy debates continue to be permeated by the "illusion of certainty".' He added: 'Transparency and honesty about risks should be an essential part of both the decision-making process and the explanation of decisions.'

The lecture notes show how poorly basic concepts of probability theory are understood, and cite miscarriages of justice

related to probabilistic statements about cot deaths and DNA profiling, and also major mistakes in the forecasting of the spread of AIDS.

The governor then took as a detailed example the importance of analysing carefully pension provision in the UK. He asked: 'What are the risks incurred in pension provision and how should they be shared among us? It is not my intention to make any recommendations. That is for the Pensions Commission next year, and the government in its turn. But I do want to show that risk is at the heart of the issue.'

He added: 'There are two ways in which government involvement can, in principle, improve risk-sharing. First, collective schemes, whether compulsory or employer-based, avoid the costs of adverse selection associated with individual provision. Second, by combining taxes on current employees with deficit finance (ie taxes on future employees), state-funded pensions can transfer risks across generations in ways private markets cannot. Alternatively, the government could issue its own longevity bonds. Private annuity providers could use them to hedge aggregate longevity risk. By assuming longevity

risk the government would make it possible for the private sector to purchase such bonds and in turn support a private market in annuities.'

The lecture concluded: 'Recognising and modelling risks means understanding the limits to our present knowledge. Communicating risk is about transparency. When information on risks is provided to the public, it is often in a form that is hard to assess. Thinking carefully about communication is important to the level of public debate. The quantity of information is less relevant than its quality – sometimes less is more. And managing risk means making choices – collective choices – on the basis of a rational shared assessment of the risks involved.'

'We cannot avoid uncertainty. So let us face up to it.' the governor concluded.

The actuarial profession's reaction to this thoughtful analysis was perhaps not as positive as it deserved, focusing on the risks of longevity-related debt rather than on the broader issues which the governor had appropriately raised. The full speech is at: [www.bankofengland.co.uk/speeches/speech234.pdf](http://www.bankofengland.co.uk/speeches/speech234.pdf)

contributions.

- ◆ The average long-term funding costs for private sector employers with final salary pension schemes is 16.1% of pensionable earnings this year. This compares to 7.6% for defined contribution schemes.

### Managing legacy and dealing with change

Michaela Barry (Sacker & Partners) considered the issues that companies and trustees need to think about when considering the impact of pension scheme closure. Employers need to get advice before taking action, and need to avoid the 'eel-trap', whereby a wind-up is triggered easily that, once started, cannot be stopped. Both the employer and the trustees need to check the trust deed and rules carefully and consider the impact of actions taken on the balance of powers. If the scheme closes but is run as a closed fund, the trustees need to have an end-game strategy.

Colin Singer (Watson Wyatt) considered the trend from defined benefit to defined contribution pension arrangements. Employer contributions to defined benefit schemes are typically much higher than they are to defined contribution schemes. There is also a big transfer of risk from the employer to the employees. The closure of defined benefit schemes to new entrants would have an impact on future job mobility as older people may not be able to gain enough of a salary increase on moving to offset the negative impact on their pension benefits.

Mervyn Walker (British Airways pensions) gave a personal perspective on the people issues arising from the British Airways pension schemes. British Airways has two legacy defined benefit pension schemes, and a defined contribution scheme for new entrants. The decision to move to defined contribution was taken during 2001–2002. The reason for the change was concern over rising costs, the risks and volatilities inherent with defined

benefit pension schemes, and for competitive reasons. British Airways has also been discussing pension issues with its defined benefit pension scheme members, in order to try and agree revised accrual and contributions. These discussions, mainly through trade unions, have so far been unsuccessful. Employees see pensions as 'important', 'complex', 'confusing', 'boring', but most of all, 'the company's problem'.

### Pension schemes and corporate activity

John Moulton (Alchemy Partners) started the presentation by explaining that people are becoming increasingly concerned over the assumptions to make regarding improvements in life expectancy of pension scheme members. But the biggest assumption people make relates to the company's longevity – for example that it will last for say 30–40 years.

The Pensions Bill originally proposed that pension fund liability would extend

to all companies in a group, to directors and their families, as well as to major shareholders. 'Clearance procedures' will be used to provide assurance to companies that corporate activity will not be deemed to have been taken to avoid pension scheme liabilities. Mr Moulton questioned whether the Department for Work and Pensions (DWP) would be able to hire staff of the appropriate calibre to deal with the volumes of requests for clearance statements that it will receive.

Ian Sykes (KPMG) explained that pension schemes are a form of corporate debt. The amount of the debt is unclear, as are the repayments of the debt. And the 'moral hazard' clauses designed to stop companies dumping pension scheme liabilities on the Pensions Protection Fund mean that the debt is not capped by limited liability. The regulator has the power to close loopholes as they arise. So corporate transactions involving pension schemes are risky.

FRS17 represents a 'best estimate' and so there is a 50% chance of a deficit calculation being too low. Pension schemes offer a range of options that can be exercised against the employer, but the cost of providing these is not fully reflected in FRS17's 'best estimate'. There are also reinvestment risks and longevity risks that are not fully allowed for. Many consultancies are now advocating the use of a solvency valuation in corporate deals.

The message to sellers is to 'be open' – buyers will spot pension scheme problems anyway. In addition, they should accept a fair-value approach to pricing and consult the trustees on what sort of deal they are willing to accept. Sellers should also avoid placing arbitrary constraints on purchasers.

**Managing risk**

Alan Rubenstein (Morgan Stanley) presented a framework called ERM, or enterprise risk management, that allows users to consider the interaction of risks on the balance sheet. Pension scheme deficits are only one source of risk. By identifying risks and assessing the impact, the idea is that controls and monitoring processes can then be put in place to mitigate risks. In some companies, pension deficits represent a high proportion of the market capitalisation. Effective management of the pension scheme assets can have a big impact on risk.

**Investment for tomorrow**

The conference finished with a lively panel debate, looking at where funds should be invested and who should provide investment advice to trustees. The view was that while actuaries provide a good starting point for seeking investment advice for pension funds, other advisers also have knowledge and ideas suitable for pension fund investment and so trustees may find it beneficial to involve more than one adviser to help with their decision-making process.

**REPORT**

**Society of Pension Consultants (SPC) strategic conference**

**25 November 2004**

**Lawrence Churchill – PPF**

The Pensions Protection Fund (PPF) is intended to provide a safety net to pension fund members based on insurance principles. It fills a role that the minimum funding requirement might have fulfilled had it worked out differently. Pension fund closures have been headline news but in reality there is a much less than 1% failure rate of defined benefit pension schemes. Their relative safety has been overshadowed by the media focus on high-profile cases.

The 'critical success' factors of the PPF are:

- ◆ Encourage stronger funding principles – this is key since the PPF does not want any 'customers'!
- ◆ Build confidence of the stakeholders.
- ◆ Risk management and early warning systems – the PPF does not want to pick up the bill for moral hazard cases. But the defences need to be appropriate and need to balance risk with practical requirements – for example it does not want to discourage corporate transaction activity.

Short-term (one- to two-year) problems are:

- ◆ Implementation issues – there are only four months to get the PPF up and running.
- ◆ Lack of data and establishing robust early warning systems.
- ◆ Balancing opposing views.
- ◆ Implementing the risk-based levy.
- ◆ Uncertainty over number of cases in the pipeline – ie schemes that are struggling on until the PPF is implemented

and will then commence wind-up.

- ◆ Building confidence.
- ◆ The unknown!

**Eric Anstee – pensions accounting**

IAS19 is filled with too many options (see above). A fundamental review of IAS19 is urgently needed to remove options, simplify language, and eliminate the corridor. Surveys show that there is low awareness of potential impact and low level of preparation for the implementation of IAS19 for listed companies or FRS17 for non-listed. Companies should explain the impact of transition to investors now to pre-empt knee-jerk reactions to financial results. The impact on share prices will depend on the level of investor understanding – there will be chaos if companies do not communicate their results well. Many companies do not expect to give extra disclosures to explain the impact of changes in accounting. Few listed companies have any communication plans – clients need their advisers' help!

**David Pollard – what legal rights do employers have?**

Do trustees have a duty to consider the interests of the employer? There are two opposing views:

- ◆ The 'wide view' says yes – trustees may consider the employer as a beneficiary. The employer is a 'negative beneficiary' in that its costs increase if things go wrong, or a 'positive beneficiary' to the extent it can gain from a surplus. Trustees may consider the interests of the employer in appropriate circumstances.
- ◆ The narrow view says no. Trustees should ignore the interests of the employer save in so far as it potentially has an adverse effect on the members.

**2006 tax simplification**

Inland Revenue limits on the amounts of benefit payable will disappear. Instead, members will face a tax charge if their benefits are over a lifetime limit. Old references in scheme rules to 'subject to Revenue limits' will cease to have effect. Scheme limits must be introduced if the liabilities are not to increase. There is limited transitional relief for schemes – to the next deed amendment or 2009 if later. There are two sets of further legislation to come in before this requirement is effective.